INDEPENDENT
SECTOR

Testimony of
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Washington, DC

United States Senate
Committee on Finance
June 22, 2004, Hearing
"Charity Oversight and Reform:
Keeping Bad Things from Happening to Good Charities"

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TUESDAY, JUNE 22, 2004,
10 A.M. EST

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EXECUTIVE SUMMARY

America's 1.4 million charitable and philanthropic organizations serve, educate, assist, enrich, and empower millions of Americans in thousand of local communities. This voluntary network is supported by tax policies that encourage giving and grant tax exemption on the condition that funds are used for the common welfare and not for private gain. The sector's greatest asset is the trust the public has placed in it, as evidenced by the tens of millions of Americans who give generously of their time, financial resources, and talents.

In recent years, the actions of a few in the charitable sector have eroded that trust. Many factors are fueling these concerns: growth in the sector and insufficient knowledge by trustees and professional staff about legal obligations and good governance; federal and state laws that are not consistently and fully enforced; annual information returns filed by charities that are confusing and inadequate; and gaps in legal framework and laws regulating the sector.

Ending unethical and illegal practice will require a multifaceted approach by both government and the voluntary sector. The current challenges do not lend themselves to quick fixes and short-term solutions. Among the recommendations are:

- Revise the Forms 990 and 990PF filed by charities and foundations to enhance the quality and transparency of information, and ensure full adoption of electronic filing of these forms.
- Eliminate barriers to shared enforcement by federal and state regulators and increase funding for oversight and enforcement.
- Amend the laws to increase penalties for wrongdoing and work with the charitable community to explore the best way to clarify rules for such issues as appropriate compensation, donor-advised funds, and valuation of gifts of property, without undercutting the program and its benefit.
- Voluntary sector should expand and coordinate successful standards and self-regulation programs and, with public and private support, increase education and technical assistance for trustees and staff leaders.

Some recommendations warrant immediate attention and implementation, while others require more careful consideration and deliberation. Actions to improve the work of the voluntary sector should not be so draconian that people of goodwill are discouraged from serving on boards, working in nonprofit organizations, or giving to causes that serve our common good. The legal framework within which charities function must not be so laissez-faire that unscrupulous people are able to manipulate the system for personal gain.

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Mr. Chairman, Senator Baucus, and distinguished Members of the Committee, thank you for inviting me to join you today at this important hearing and for the opportunity to share with you my recommendations concerning actions that must be taken by the nonprofit sector and by government to strengthen the transparency, good governance and accountability of voluntary organizations. These recommendations are intended to build on some of the initiatives underway in the nonprofit sector that are dedicated to improving governance and practice. Our public charities and private foundations appreciate your deep concern and your willingness to work with us to separate the thousands of good actors from the few bad actors and, in so doing, preserve all that is valuable in America's nonprofit sector.

INDEPENDENT SECTOR is a nonprofit, nonpartisan membership organization committed to strengthening, empowering, and partnering with nonprofit and philanthropic organizations in their work on behalf of the public good. Our coalition of approximately 600 nonprofit organizations, foundations, and corporate philanthropy programs collectively represents tens of thousands of charitable groups as well as millions of donors and volunteers serving a wide range of causes in regions across the country.

I. CONTRIBUTIONS OF THE CHARITABLE AND PHILANTHROPIC SECTOR

Throughout our history, America's nonprofit organizations have played a critical role in advancing the well being of society in the United States and abroad. Since this country's earliest days, philanthropy and charitable organizations have dedicated themselves to strengthening community life, serving the most disadvantaged members of society, enriching our knowledge, encouraging creativity, improving our health and welfare, and contributing to our democratic way of life. Working independently and in concert with government, the charitable sector has served as the vehicle through which many of our collective responsibilities have been discharged. Through its collaborative work with government, and the private actions of its 1.4 million education, health, social service, religious, and public interest organizations, among others, the charitable sector has improved the quality of life for generations of people.

Among its many contributions, America's voluntary endeavors have advanced positive social change in our country and contributed to such movements as the abolition of slavery, women's right to vote, the creation of public education, the welcoming of immigrants to our shores, and the strengthening of civil rights and liberties of our citizens. To be sure, our work is not yet done. But there is much of which to be proud. Philanthropic initiatives enabled Jonas Salk's work that resulted in the polio vaccine;

built the great museums of America; advanced rocket science research; and created the 911 emergency telephone system. Today's great works by the nonprofit sector are illustrated through these few examples:

- The Mid-South Delta Initiative promotes economic development in 55 counties and parishes along the Mississippi River in Arkansas, Louisiana, and Mississippi. In the last 18 months, this group's partners have started two dozen businesses, created approximately 1,500 jobs, and built or rehabilitated 300 homes for low-income families.
- Big Brothers Big Sisters, headquartered in Pennsylvania, taps into a network of volunteers from houses of worship and other community-based groups to provide one-on-one mentoring to over 200,000 children across all 50 states.
- The Central Park Conservancy, a nonprofit organization, raises funds and mobilizes volunteers to provide all basic care and to support more than 85 percent of the budget for New York City's award-winning urban park. The park is visited annually by over 25 million visitors from the United States and around the world.
- The John D. and Catherine T. MacArthur Foundation has launched a $50-million Science, Technology and Security Initiative that will work in partnership with leading universities to cultivate a new generation of experts on science and security issues who will provide vital data to government and policymakers to combat terrorism and technologies for mass destruction.

Nonprofit organizations, both large and small, each day serve, educate, assist, enrich, and empower millions of Americans in thousands of local communities. Voluntary organizations and the individuals who serve them have improved virtually every corner of our community landscape.

The growth and renewal of our national voluntary network of public charities and private foundations is facilitated by an invaluable tax policy designed to stimulate the impulse to give to a wide array of institutions serving the public good. The tax-exempt status nonprofit organizations enjoy requires the funds that support these activities to be used, not for private gain, but for the common welfare.

Among the charitable sector's most significant assets, however, is the trust the public has placed in it. This is based on the belief in the high purpose of the missions of charitable organizations and confidence that their leaders will serve the common welfare and will not profit financially from the work of the organization, beyond reasonable compensation for services rendered. The public assumes that boards of trustees will govern in a manner that is responsible, accountable, and ethical. The support and trust the sector enjoys is clearly evidenced by the tens of millions of Americans who give generously of their time, financial resources, and talent to nonprofit institutions in the United States and around the globe.

In recent years, the actions by some in the charitable sector have eroded that trust. The stories reported in media outlets across the country over the past year, now numbering in the hundreds, have detailed examples of alleged excessive compensation of executives, self-dealing, questionable fundraising practices, conflicts of interest, and lavish

expenditures. While these stories refer only to a handful of organizations—indeed only a minute percentage is responsible for such problems—the sector as a whole faces a "spillover effect" in which the good work of thousands is threatened by the actions of a few. Thus, the sector as a whole is called upon to address these issues in order to maintain public confidence in its work. There is much that needs to be done, and we will be encouraging you, as well as other federal and state public officials, to assist in this process.

II. REGULATIONS GOVERNING THE CHARITABLE SECTOR

A. Qualification for Tax-Exempt Status

Charitable nonprofit organizations, as defined under section 501(c)(3) of the Internal Revenue Code (IRC), must be exclusively dedicated to purposes that advance the public good. Where other types of nonprofit organizations benefit the private social or economic interests of their members,[1] charitable organizations must benefit the broad public interest and Congress has therefore provided, with very limited exceptions, that only those charities organized under section 501(c)(3) are eligible to receive tax-deductible contributions.

To be recognized as a charitable organization, an organization must satisfy the requirements outlined under section 501(c)(3) of the Internal Revenue Code based on an application and examination by the Internal Revenue Service. The application details the charitable purposes the organization will serve, the sources of funding the organization has received or expects to receive and its plans for spending those funds, members of the organization's governing board and the rules they will follow in governing the organization, and other information relevant to the IRS's determination as to whether the organization meets the criteria under section 501(c)(3) or other sections of the IRC.

The Internal Revenue Code further classifies 501(c)(3) organizations as either public charities or private foundations. A public charity must document that it meets certain operational conditions (e.g., that it is operating or will operate as a school, hospital, or religious institution), normally derives at least one-third of its annual financial support from the general public in the form of qualifying contributions and grants, or that it will function as a "supporting organization" to one or more specific organizations that meet the required support tests. A private foundation generally derives its financial support from the contributions of a single individual, family, corporation, or other entity. Private foundations receive less favorable charitable tax deduction treatment for their donors and are subject to substantially more restrictive rules governing their operations.

B. Disclosure Requirements

With the exception of religious institutions, all tax-exempt organizations are required to file an annual information return, the Form 990, with the Internal Revenue Service if they have annual revenues of $25,000 or more. The form provides details on the

[1] The Internal Revenue Code defines over 27 categories of organizations that are exempt from federal income taxes, including private country clubs, business associations such as Chambers of Commerce or the National Association of Manufacturers, labor unions, fraternal organizations, and many others.

organization's revenues and expenses for the year; net assets; officers, trustees, directors and key employees and their compensation; income-producing activities and information on taxable subsidiaries; and a statement of program service accomplishments. An extensive list of other reportable facts, many of which are applicable only to specific categories of exempt organizations, are also requested on the Form 990. Public charities are required to attach an accompanying schedule (Schedule A) that details compensation of the five highest paid employees and the five highest paid independent contractors, eligibility for non-private foundation status, lobbying expenditures, and transactions with other organizations. Public charities with gross annual receipts of less than $100,000 and total assets that are less than $250,000 in value at the end of the year may choose to file the shorter, simplified Form 990EZ.

C. Special Requirements of Private Foundations

Private foundations file a different annual information return, the Form 990PF. This form also requires information on revenues and expenses, assets and liabilities, compensation of trustees and officers, and grants programs and other activities. Private foundations (other than exempt operating foundations) are subject to an annual excise tax of 2 percent of their net investment income[2] and must make "qualifying distributions" equal to at least 5 percent of the value of their non-charitable assets. Qualifying distributions include gifts of money and/or property to charitable organizations and, under specific prescribed conditions, to individuals, as well as other costs related to carrying out the charitable work of the foundation. Private foundations are also subject to specific rules prohibiting self-dealing between the foundation and disqualified persons, including major contributors, foundation managers, and their family members, and corporations or partnerships controlled by major contributors and managers; prohibiting the investment of its income or principal in a manner that would jeopardize its tax-exempt charitable purposes; and prohibiting engagement in most lobbying and related efforts to influence legislation beyond self-defense activities. Officers, directors, and other "disqualified persons" who engage in acts of self-dealing are subject to both a penalty tax and an obligation to make the foundation whole. Participation in any other prohibited activity subjects the foundation to specific tax penalties.

D. Intermediate Sanctions

In 1995, Congress passed new legislation that requires the IRS to impose tax penalties on individuals and corporations that have received "excess benefits" from transactions with public charities and the managers and directors of the charities who permitted such transactions knowing they were improper. An "excess benefit" occurs when the value of the economic benefit (generally cash or property) provided directly to an individual or company exceeds the value of the service or good received by the charity in exchange for that benefit. INDEPENDENT SECTOR and its members were engaged actively with Congress in the development of this provision, known as "intermediate sanctions," and have worked to advise organizations about how to comply with the new provisions of the law.[3]

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[2] Under specific circumstances, the excise tax can be reduced to 1 percent in years where the foundation's qualifying distributions have increased by an equivalent amount.

[3] INDEPENDENT SECTOR's publication, *Intermediate Sanctions: What You Need to Know,* is available on its website.

E. Other Applicable Statutes and Regulations

In addition, charitable nonprofit corporations must adhere to a wide range of other federal, state, and local laws, regulations, and reporting requirements that are often overlapping and complex. In most states, nonprofit corporations must file annual or biennial reports with the Secretary of State or the Attorney General. Nonprofit corporations must also apply for and maintain local property tax exemptions, and also comply with local laws regulating business licenses and charitable solicitations. Charitable solicitation, in particular, is an area closely regulated by most states. Today, almost all states have some kind of law or regulation governing charitable solicitations. These regulations cover the use of professional fundraisers, co-ventures with for-profit enterprises, licenses, and registration and reporting requirements. Nonprofit organizations must also comply with laws governing restricted donations, and directors have a duty to comply with donor restrictions. Some states also place limitations on the use of income from endowment funds.

Directors of nonprofit organizations are also subject to a wide range of well-established and codified legal duties and responsibilities. These duties are grounded in common law and state and federal statutes. The standards of conduct and duties of directors include the obligation to be attentive to the affairs of the corporation (duty of care) and to act in the best interest of the institution (duty of loyalty). Many states have statutes that define and govern what is required when a director has a significant personal interest in a transaction or decision of the entity.

III. FACTORS FUELING ACCOUNTABILITY CHALLENGES

The outpouring of generosity immediately following the terrorist attacks of September 11, 2001, catapulted the charitable sector to new heights of visibility, resulting in media scrutiny and the expression of Congressional and public concern regarding the distribution of some funds that had been collected. Since then, investigative reports in newspapers nationwide have examined the inner-workings of some nonprofit organizations and foundations, including possible cases of conflicts of interest, questionable compensation to trustees or staff, and public charity fundraising practices. A number of these practices, if true, are unlawful, while others break the bounds of sound governance and ethical conduct. While only a handful of organizations and individuals are engaging in such behavior, the egregious nature of these reports has raised questions about the entire charitable sector's credibility and threatens to weaken the public trust. Research by Paul Light, a senior fellow at the Brookings Institution and professor at New York University, reveals that public confidence in the charitable sector was shaken in 2001 and has yet to rebound. There are several factors contributing to these problems:

A. Growth in the Sector

Over the last quarter century, the charitable sector has grown at more than double the pace of its for-profit counterpart. The total number of public charities, foundations, religious congregations, and other groups has grown from 739,000 organizations in 1977

to an estimated 1.4 million organizations today. Small organizations (those with less than $5,000 in annual revenues) are not required to register with the IRS and, if counted, would increase the number of nonprofits even more.

This is a sector with expenditures of over $875 billion each year employing 11.7 million workers, roughly 9 percent of the workforce in the United States. Nonetheless, more than 70 percent of charities have annual budgets of less than $500,000.

In this rapidly expanding domain, many professional leaders and board members elect to work in the voluntary sector because of the opportunity to contribute to society. Among them are professional leaders and board trustees who may not be sufficiently knowledgeable about either the legal obligations associated with running a nonprofit or the requirements for good practice and governance.

B. Inadequate Enforcement

A major problem for the nonprofit and philanthropic sector is that federal and state laws pertaining to oversight of the voluntary sector are not consistently and fully enforced. While the IRS Exempt Organizations Division plans to hire an additional 72 examination agents this year, the number of employees in the tax-exempt division is still not up to the level of a decade ago when the sector was significantly smaller. With 90,000 new organizations seeking tax-exempt status annually—an almost 50 percent increase in the last 10 years—much of the exempt division's resources are devoted to determining whether to approve applications. The IRS's audit rate has been falling for some time and is currently under 1 percent of returns filed annually. State charity officials estimate that over half their limited resources allocated for oversight and enforcement of charitable nonprofits are consumed by processing paper copies of the Forms 990, 990PF and other registration materials. Federal legal restrictions on information sharing between the IRS and state charity regulators further inhibit effective oversight and enforcement.

C. Confusing and Inadequate Reporting

While regulators spend a great deal of time processing Forms 990 and 990PF, the financial information reported too often is incomplete, late, or inconsistent with that of similar organizations, and does not enable easy identification of problems or abuse.

There are significant differences in the accounting methods used by some nonprofits to record fundraising and administrative expenses, and the IRS forms do not adequately allow explanations of variances caused by financial transactions such as restricted funds received in prior years or pledges for contributions that have not yet been received. Reporting requirements call for recording of such data the year in which the pledge was made or the grant received, and not in the year in which the funds were spent. As a result, financial statements may give the false impression of irresponsible fiscal management or an inaccurate picture of successful operations. The forms also do not require that organizations clearly distinguish transactions with board members, staff, or others that involve potential conflicts of interest.

D. Cost of Doing Business in Today's Fiscal Climate

One of the most difficult challenges charities face is securing adequate resources to serve their missions. Both private and public sources of funds have been constrained recently by fluctuations in the economy and federal and state budget deficits. At the same time, costs of doing business have continued to increase. Lower salaries and reduced benefit packages often make it difficult for some charities to attract highly qualified staff where stakeholders expect particular services to be carried out by highly qualified professionals. In the case of nonprofit hospitals situated in cities with very high housing costs, attracting top-level physicians to fill some positions without offering supplemental housing help has been very difficult. For some positions, such as financial investment professionals who are part of the team responsible for managing substantial investment portfolios, it is difficult to attract or retain staff unless they are paid market rates. Nonprofits also are being pressed to streamline practices and run more efficient operations, drawing on innovations in technology and the demonstrated success of other organizations. These worthy investments require additional resources, which are not readily available.

Given the intense competition for resources, some public charities have sought alternative forms of fundraising without the requisite expertise to manage such ventures. The urgent need for resources has created a climate in which unscrupulous profiteers successfully have persuaded some charities to team up on schemes that have produced a small benefit for the charity while violating common sense standards of good business practice.

E. Legal Framework and Regulations Lag Behind Changes in the Sector

State and federal laws and regulations governing the charitable sector have not always kept pace with changes in fundraising practices and the development of new vehicles to promote charitable giving, thereby creating gaps in the legal framework that have allowed individuals who profit unduly from "charitable" endeavors to go undetected and unpunished.

Donor-advised funds were initially created in part as an alternative to the legal requirements for private foundations that inhibited donors of more modest means from engaging more fully in philanthropy. These funds are administered primarily by community foundations and other established charities that have instituted internal policies and practices to prevent intended or unintended abuse by individual donors for their private benefit. The legal framework for donor-advised funds has provided an opening for a few individuals and for-profit entities to set up funds that operate primarily as tax shelters, rather than truly serving charitable interests, allowing such donors and their financial advisors to maintain inappropriate control over investment of the funds and to direct resources to pay personal expenses of the donors and their family members.

The rising cost of steel and scrap metal has generated a growing market for used vehicles that can be dismantled and resold for the value of their parts. Many charities have become involved in vehicle donation programs that address this market niche while generating valuable resources to support the charities' service programs. While many of these vehicle donation programs operate responsibly and provide substantial needed resources for charities, others offered by outside vendors operating on behalf of charities have

inappropriately encouraged taxpayers to claim exaggerated tax deductions for their donated vehicles, while providing minimal returns to the charitable organizations. The lack of clear standards for determining the value of these contributions for the purpose of tax deductions has produced confusion and both intended and unintended misuse of the important tax incentive provided by the federal government to encourage charitable giving.

In recent years, there have been a growing number of reports of individuals who have created charitable organizations that serve primarily as vehicles for various fundraising or financial services vendors to gain lucrative contracts for private gain, leaving minimal resources for legitimate charitable activities. These activities are not apparent in the initial applications for recognition as charitable tax-exempt organizations filed by the organizations and, without careful review, may not be detectable in the annual Forms 990 filed by the organizations.

F. Diversity of the Sector and Changing Standards of Behavior

The voluntary sector comprises a broad band of organizations with different missions, operations, and spheres of endeavor. In this diverse mosaic, it is difficult to achieve a one-size-fits-all set of standards to cover adequately compensation and benefits, board structures, fundraising practices, and other governance and management issues.

Some of the questionable practices, though not the most egregious ones detailed in news stories, have been in place for years. Charities and foundations have gone about their business with limited collective thought concerning general standards for board compensation, fundraising efforts, and travel and hotel arrangements, among other practices. For some, generous latitude on particular practices was seen to be part of the cost of doing business with major donors or a benefit of working in a nonprofit field that did not offer competitive salaries with the for-profit sector. Just as the standards for practice are changing in corporate America and government, what might have been considered within the domain of acceptable organizational procedure in the past is now appropriately being examined by the sector itself.

IV. STEPS TO ADDRESS ACCOUNTABILITY CHALLENGES

Preventing, discouraging and eliminating unethical and illegal practice within the voluntary sector will require a multifaceted approach that depends upon the involvement of both government and the voluntary sector. No singular action will succeed in fully addressing the issues at hand. Nor do the current challenges lend themselves to quick fixes and short-term solutions. Moreover, it is important that corrective efforts do not produce outcomes that might stifle the great American traditions of giving and of volunteering. Actions to improve the work of the voluntary sector should not be so draconian that people of goodwill and honorable intent are discouraged from serving on boards, working in nonprofit organizations, or giving to causes that serve our common good. Equally important, the framework within which we function must not be so laissez-faire that unscrupulous people are able to manipulate the system for personal gain.

To be effective, some of the reform efforts must be undertaken by the charitable community itself. It is our task to set standards and guidelines for effective practice; it is our job to educate our colleagues in the sector about good governance and proper procedures; and it is our responsibility to encourage ethical, accountable and transparent practice. The charitable community must increase and improve its efforts to set clear standards of practice for management and governance and, in concert with government, establish the systems and services necessary to ensure adherence to those standards. With public and private funding, the voluntary sector can and should offer training and technical assistance to those who need education and guidance in good governance and ethical practice.

Government must see to it that the law is upheld and that wrongdoing is deterred and dealt with appropriately. Where legal remedies and regulations do not address adequately a particular abusive practice, it is prudent to consider carefully additional action that specifically addresses the problem at hand and ensure that the proposed remedy does not injure the rest of the sector.

One of the major challenges of the day is the capacity to identify easily possible wrongdoing. Public officials and other interested parties ought to have access to accurate, comprehensive, and current information on the financial operations, governance practices, and program activities of public charities and private foundations. Such information is needed to enforce relevant laws and regulations and allow donors to make informed decisions about how charitable organizations operate or benefit the public good.

Both state and federal agencies charged with regulation and oversight of charitable organizations must have the necessary resources to fulfill their duties. This includes more personnel, improved information sharing systems between federal and state regulators, and updated technology that allows for electronic filing and data collection.

The following recommendations are intended to serve as a framework for transparent, accountable, and ethical practice within the sector.

A. Improving the Quality and Transparency of Information

1. Revise Forms 990 and 990PF to Provide More Consistent, Timely, and Useful Information About Financial and Other Governance Issues

The Form 990, filed annually by tax-exempt organizations with gross annual revenues of more than $25,000, and Form 990PF, which is filed by private foundations, have become the primary sources of information on charities and foundations. These forms are currently filed in paper format with the IRS and with state charity offices where the public charity or private foundation operates. Through the generous support of several private foundations, these forms are available on the Internet for free inspection by the public through GuideStar/Philanthropic Research, Inc. Yet the time and cost involved in processing these forms, first by the IRS and then by GuideStar, means that

information is several months or even years old before it is accessible to the public. Furthermore, in their current design, these forms fall woefully short of providing a clear, useful tool for the public, for regulators, and for nonprofit practitioners who must complete the form. ***The Forms 990 and 990PF must be significantly revised and re-formatted, in consultation with accounting and legal experts and practitioners from the charitable community.***

In January 2003, INDEPENDENT SECTOR submitted comments to the IRS recommending several changes to the Form 990 to gather more specific, clear information on related party transactions, governance practices (such as conflict of interest policies and independent audit committees), and the availability of audited financial information. The Council on Foundations has submitted numerous recommendations to the IRS in recent years for changes to the Form 990PF to improve its utility and to clarify and simplify the process of providing accurate, relevant information through the form. Recently, the American Institute of Certified Public Accountants Tax Exempt Organization Taxation Technical Resource Panel submitted several other suggestions to the IRS to improve the quality and utility of the Form 990, including the very helpful suggestion that a new form be developed for organizations exempt under section 501(c)(3) and 501(c)(4) and a separate form for all other categories of exempt organizations.

The IRS established a committee in 2003 to "redesign the Form 990 to make it a tool for EO [Exempt Organizations Division] to improve identification of compliance issues while continuing to serve as an informative document for any entity's contributors and other members of the general public."[4] The changes are expected to be complete for incorporation into the fiscal year 2005 Form 990 reports that will be filed in 2006. INDEPENDENT SECTOR and many other nonprofit organizations, research centers, and private foundations stand ready to work with Congress and the IRS to ensure that revisions will better address the interests of the public, government regulators, and the charitable community.

2. Implement Electronic Filing of Forms 990 and 990PF and Create a More Integrated Public Disclosure System

Manual processing procedures currently consume substantial resources at the IRS and at state charity offices. Better use of these funds would be possible if electronic filing were required of all nonprofit organizations. Electronic filing would allow the IRS to provide immediate feedback to filers and reject forms that are incomplete or that have conflicting information. This would in turn improve the quality of information and reduce the cost of correcting unintentional errors for both regulators and charities. Furthermore, electronic filing would reduce the cost and time involved in making the forms available for public inspection. By making electronic filing mandatory, Congress moves us closer to a system that is transparent and accessible to regulators, donors, media, researchers, and the

[4] *IRS FY 2004 EO Implementing Guidelines, September 2003.*

public at large. Electronic filing would make it possible for all interested parties to differentiate more easily the good actors from the bad.

The IRS has made measurable progress in implementing an electronic filing option for these forms and earlier this year received its first electronically filed Form 990. Electronic filing for the Form 990PF is expected to be available in early 2005. The IRS has been working on a system to integrate electronic filing on both the federal and state levels, but is still seeking funds to support this important effort. Virtually all state charity offices lack the funding to implement their own electronic filing systems or to access any integrated systems developed by the IRS. ***Congress should ensure that the IRS has sufficient funds to implement its full e-filing initiative, including its federal-state access program, in the next two years, and ensure that funding is provided to enable state charity offices to utilize the IRS system.***

Currently there are few software options that nonprofit organizations and their tax preparers can use to e-file their returns. Due to the foresight and support of several private foundations, there is a free software option for e-filing the Form 990EZ that is offered by the National Center for Charitable Statistics. Many commercial software firms that support the accounting and tax preparation work of most nonprofits and their tax advisors are planning to add an e-filing option to their packages, but without sufficient incentives or requirements for nonprofits and foundations to e-file their returns, software firms are hesitating to make the investment the e-filing option would require.

With appropriate software, electronic filing should be within the reach of most public charities and private foundations. A 2002 study conducted by the National Center for Charitable Statistics revealed that 80 percent of Forms 990 submitted by public charities are prepared by paid tax professionals, who generally have access to current accounting and tax software. ***Congress should consider requiring electronic filing of the Forms 990 and 990PF by paid tax preparers and by larger nonprofits and foundations, thus ensuring that software developers will respond to this growing need. Appropriate phase-in periods and revenue thresholds should be developed in consultation with the charitable community and financial experts.***

Electronic filing, while cost effective in the long run, does require a one-time investment to change to such a system. This cost may be beyond the financial capacity of smaller organizations that do not use paid preparers or lack the necessary technology. The Electronic Data Initiative for Nonprofits (EDIN), led by INDEPENDENT SECTOR and the Council on Foundations, has worked for the past three years to advance electronic filing of the Forms 990 and 990PF at the state and federal level and resolve obstacles to the widespread adoption of e-filing.[5]

[5] Other members of EDIN include the National Council of Nonprofit Associations, GuideStar, and OMB Watch. The National Center for Charitable Statistics serves as an advisor to the coalition. Funding has been provided by seven private foundations.

While private philanthropy has been and will continue to provide crucial support to this effort, ***Congress should ensure that sufficient public resources are available to make certain that smaller organizations have the necessary access to the Internet and the appropriate technology to utilize electronic filing.***

3. Updating the Certification Process for Charitable Tax Exemption

There is an interest by some in a more thorough examination of a sampling of public charities from time to time to ascertain whether the organizations continue to meet the requirements for recognition as charitable tax-exempt organizations. Such a review might include the most recent version of the charity's organizing and governing documents, detailed information on major vendor contracts, and information on the types of services provided by the charity. Some information currently required on the Form 990 might be more suitably addressed in a new long form that charities would only complete every five or seven years.

If such a review is contemplated, before it is implemented, ***Congress should take steps to ensure that the Internal Revenue Service has sufficient resources to carry out an effective review process. The form should be designed carefully in consultation with the charitable community to ensure that the goal of identifying organizations that are serving improperly as conduits for private gain is met without imposing unnecessary administrative costs on responsible charities.***

4. Standardizing and Correcting Financial Standards for Nonprofit Organizations

A further problem with analyzing financial information reported by nonprofit organizations on the Form 990 is the lack of consistent, reliable, and clear financial standards that are followed by all organizations. The Financial Accounting Standards Board (FASB) is the independent, private agency charged with setting financial accounting and reporting standards for nonprofit organizations. These standards, known as Generally Accepted Accounting Principles (GAAP), are used in preparing audited financial statements, which many nonprofit organizations are required to provide with grant applications and reports to state and federal funding agencies, private foundations, and other donors. The standards have evolved significantly over the last 20 years, with new Statements of Financial Accounting Standards (SFAS) issued to clarify rules for specific types of financial transactions.

While the FASB standards have served to make audited financial statements more comprehensive and transparent generally, many scholars and nonprofit and accounting practitioners argue that some aspects of the standards instead have distorted the representation of a nonprofit's financial standing. Robert N. Anthony, professor emeritus at Harvard University, has been sharply critical of the SFAS No. 116 and No. 117 issued by FASB in the mid-1990s and stated that

"SFAS No. 117 challenges the accountant to find a sensible way of preparing an operating statement for nonprofit organizations that have contributed endowment, plant, or museum objects. The statement mixes operating transactions with nonoperating transactions and leads to what many believe to be a useless bottom line."

Many have suggested that the IRS revise the Form 990 to reflect GAAP standards and consider requiring all nonprofits to adhere to the GAAP standards. Such a measure would only be helpful to donors, regulators, nonprofit managers, and board members if the FASB standards were corrected to address the issues raised by SFAS No. 116 and 117. As FASB is primarily focused on the needs of for-profit businesses and its board is almost entirely composed of business leaders and managers from the for-profit world, FASB should establish a new review panel of scholars, accounting professionals, and nonprofit practitioners to revise GAAP standards for nonprofit organizations. While FASB standards are not under the jurisdiction of Congress, it would be helpful for ***Congress to direct the Internal Revenue Service to consult with FASB and the charitable community about amending the standards when revising the Forms 990 and 990PF.***

B. Strengthen Federal and State Oversight and Enforcement

1. Increase Funding for Federal and State Charity Regulators

Federal and state offices charged with oversight and regulation of charitable organizations and activities need substantially more resources to ensure appropriate levels of education, oversight, investigation, and enforcement. The number of charitable organizations and private foundations and the applications for tax-exempt status have increased dramatically in the last decade, while resources in the Exempt Organizations Division of the IRS have declined.

In legislation enacted in 1969 that imposed an excise tax on private foundation investment income, Congress made clear that vigorous and extensive administration would be needed to ensure that private foundations promptly and properly use their funds for charitable purposes. The rationale for the excise tax on private foundation investment income was formalized by Congress in 1974 when it passed legislation creating the Internal Revenue Service Office of the Assistant Commissioner for Employee Plans/Exempt Organizations and permanently authorized an appropriation tied to the tax to pay for the expenses of the new division. This appropriation was never made, however, and the amounts raised by the excise tax—now estimated at about $500 million annually—have been funneled into general revenues appropriated for unrelated purposes. ***We urge that these authorized funds or other revenues be authorized and appropriated specifically for IRS and state charity regulators for oversight, education and enforcement.***

There is considerable reluctance in many parts of the sector to accept the levy of additional fees for this purpose, given the history of the excise tax, and the financial challenges so many public charities face at the present time. ***If, however, an additional fee is under consideration, we urge that it be accompanied by a careful analysis of its impact on organizations that do not have sufficient resources to meet their current obligations. Exceptions should be made for organizations that cannot afford to pay such a fee.***

2. Remove Barriers to Shared Enforcement Efforts

One of the challenges state and federal charity regulators face in coordinating efforts to investigate and prosecute charitable abuses is the confidentiality rules established in Section 6103 of the Internal Revenue Code. INDEPENDENT SECTOR and the National Association of State Charity Officials (NASCO) have endorsed provisions in the CARE Act and the Tax Administration Good Government Act that would allow the IRS to disclose to appropriate state officers certain information about investigations related to the determination to deny or revoke tax-exempt status. Both of these provisions would permit the IRS to disclose such information only to state officials charged with overseeing tax-exempt organizations and the information could be used only to administer state laws regulating tax-exempt organizations. A report issued on June 9, 2004, by the IRS Advisory Committee on Tax Exempt and Government Entities (ACT) notes that the proposed provisions in the CARE Act and the Good Government Act "would significantly increase the effectiveness of both EO (Treasury) and state regulators by allowing them to coordinate their investigative and audit activities where appropriate."

In its report on H.R. 1528 Taxpayer Protection and IRS Accountability Act of 2003, the House Ways and Means Committee stated that it "believes state officials charged with oversight of organizations described in section 501(c)(3) have an important and legitimate interest in receiving certain information about such organizations before the IRS has made a final determination with respect to an organization's tax-exempt status or liability for tax. By providing state officials with early access to information about the activities of section 501(c)(3) organizations, regulators will be able to monitor organizations more effectively and better protect the public's interest in assuring that charitable contributions are used for charitable purposes. The Committee stresses the importance of maintaining the confidentiality of taxpayer returns and return information and believes it is important to extend existing protections against unauthorized disclosure or inspection of return and return information to disclosures made or inspections allowed by the Secretary of return and return information regarding section 501(c)(3) organizations."

We concur with the Committee's assessment of both the importance of taxpayer confidentiality and of the need to provide information to law enforcement officials, including those charged with oversight of charitable organizations.

Congress should ensure that these provisions are enacted into law as quickly as possible.

A further barrier to effective coordination of efforts to address abuses lies within the maze of conflicting state charity rules and regulations. Current regulations often create more work and expense for responsible nonprofits while complicating joint investigation and enforcement efforts to stop those who intentionally use charitable organizations for private gain. In the mid-1980s, the National Association of State Charity Officials (NASCO) developed a model charitable solicitation act that has provided useful guidance to individual states in developing their own legislation. That model act has not, however, been updated since its release in 1986. ***Congress should consider requiring the appropriate federal agencies to develop uniform federal regulations in consultation with state charity officials and the charitable community that would allow for greater cooperative enforcement and information sharing among states and with the IRS.***

3. Strengthen the Laws

In some cases, existing laws and regulations have not kept pace with changes in the sector and have not prevented the introduction of new schemes that direct charitable and philanthropic resources for private gain. ***Policymakers and nonprofit leaders should work together to explore possible changes in the laws to curb abuses that may not be addressed adequately through existing laws.***

i) Lessons from Sarbanes-Oxley. Some have proposed that provisions of the Sarbanes-Oxley Act,[6] which was developed to correct malfeasance within the corporate sector, might be applied to the charitable sector as well. Several states, including New York and California, have introduced legislation primarily focused on larger nonprofits that includes requirements such as the establishment of independent audit committees, certification of financial documents by the Chief Executive Officer (CEO) and Chief Financial Officer (CFO), and restrictions on interested party transactions. INDEPENDENT SECTOR, in conjunction with BoardSource, has developed guidelines and recommendations on how nonprofits voluntarily might apply relevant sections of Sarbanes-Oxley legislation to their practice. We recognize that many of those provisions will not be applicable or economically feasible for adoption by all charitable organizations. ***We recommend that Congress consider carefully proposals to apply Sarbanes-Oxley provisions to nonprofit organizations to determine whether the particular provisions are relevant and helpful to effective governance and oversight and ensure that exemptions apply to smaller organizations that are unable to afford the cost of implementing these provisions.***

[6] The American Competitiveness and Corporate Accountability Act of 2002, commonly known as the Sarbanes-Oxley Act and enacted in 2002, requires publicly traded companies to adhere to significant new governance standards that broaden board members' roles in overseeing financial transactions and auditing procedures.

ii) Board and Staff Compensation. Media reports have raised legitimate questions about compensation for board members and staff executives. Many trustees of public charities make generous contributions of both time and money to the organizations on whose boards they serve. While the vast majority of trustees of charities and foundations serve without receiving compensation, the nature of the work and expertise needed by some board members, particularly for some foundations, may require fair and reasonable compensation. When trustees are compensated for serving on a board or any committee, care must be taken to ensure that compensation levels are transparent, fair, and reasonable, and take into account the nature and amount of work required of trustees as well as benchmarks from comparable institutions. Compensation levels should be fixed by an affirmative vote of a majority or higher percentage of the board of trustees, and reported clearly and fully on the Form 990 or 990PF filed by the organization.

Congress has a long and proud history of supporting and strengthening the capacity of the nonprofit sector. To be effective, nonprofits must have the ability to attract a wide variety of qualified individuals to serve as board members. Policymakers should be mindful not to support policies that create a disincentive to serve on a nonprofit board. ***As Congress considers clarifying legal standards for trustee compensation, careful study will be required to ensure that legislation does not produce the unintended consequence of making board service too onerous and unappealing for individuals whose expertise is needed or where substantial time is necessary for the proper discharge of responsibilities.***

Excessive compensation for both board members and staff executives of public charities is currently addressed by "intermediate sanctions" provisions in the Internal Revenue Code [IRC (section 4958)]. The IRS can impose an excise tax equal to 25 percent of the amount of the excess benefit on any disqualified person who receives that excess benefit and an additional tax if the excess benefit is not corrected or repaid within a specified period. An excise tax of 10 percent of the excess benefit (up to a maximum of $10,000) also can be imposed on organization managers who participated in an excess benefit transaction, knowing that the transaction was improper.

Restrictions on "self-dealing" for private foundations allow compensation to disqualified persons for the performance of services that are reasonable and necessary to fulfill the charitable purposes of the foundation, as long as that compensation is not excessive. These restrictions are similar to the "intermediate sanctions" rules, but penalties are significantly lower. An initial tax of 5 percent of the amount involved in the "self-dealing" violation can be imposed on the disqualified person benefiting from the transaction and a tax of 2½ percent can be imposed on any foundation manager who knowingly participated in the act of self-dealing. In 2003, Senator Kay Bailey Hutchison (R-TX) introduced legislation (S.1514) that would increase the excise taxes on self-dealing for

private foundations from 5 percent to 25 percent. ***Congress should consider, where appropriate and useful, making the rules concerning excessive compensation for public charities and private foundations more consistent and imposing the more severe penalties on excessive compensation and acts of self-dealing proposed by Senator Hutchison.***

iii) Gifts of Tangible and Intangible Property. Questions have been raised about the validity of appraisals and other methods used to support claims for tax deductions by donors of both tangible and intangible property. A December 2003 report on in-kind contributions of motor vehicles from the General Accounting Office, prepared at the request of the Senate Finance Committee Chairman, has noted problems in the enforcement of existing laws for both individual taxpayers and public charities and the need for greater clarity regarding appropriate valuation methods for establishing deductible amounts.

The Senate recently passed legislation that would address this discrepancy by limiting a taxpayer's deduction to the amount received by the charity through the eventual sale of the vehicle. We share concerns expressed by the Joint Tax Committee in their assessment of the Senate proposal that "the price at which the charity sells the donated vehicle is beyond the control of the donor and may not approximate fair market value." The House has now passed an alternative proposal included in President Bush's 2005 budget proposal that would require independent appraisals to support deductions claimed by taxpayers for donations of motor vehicles. This alternative proposal offers a more workable solution that would address issues raised in the December 2003 GAO study, without unduly harming reputable charities that rely on these services to support vital programs.

We believe that changes are necessary to ensure that donors are not taking excessive deductions for charitable donations. The charitable community has recommended that the IRS amend the Form 8283 (that taxpayers must submit to the IRS when they claim total tax deductions of $500 or more for gifts of property) to specifically address the calculation of tax deductions for donated vehicles based on the "guidebook value" minus "adjustments for condition" to determine "fair market value" and to record Vehicle Identification Numbers (VIN) for donated vehicles. ***Congress can assist the charitable community in requiring these changes and further clarifying the basis taxpayers should use in calculating tax deductions for contributing motor vehicles and other tangible property. At the same time, Congress should take care not to increase so greatly the cost and complexity of making these important charitable contributions that it eliminates the incentive to make such donations.***

Further guidance on the issue of curbing excessive tax deductions for gifts of tangible property is provided in the final report of a special advisory panel created by The Nature Conservancy, which was chaired by Ira M. Millstein.[7] The

[7] The Nature Conservancy Governance Advisory Panel was chaired by Ira M. Millstein, senior partner of Weil, Gotshal & Manges LLP.

advisory panel noted that, consistent with tax laws, the Conservancy has not taken positions on the value or deductibility of any easement or gift of land and undertook its own appraisals to determine whether the prices paid or received by the Conservancy were supported but not to determine the propriety of the donor's appraisal. The panel recommended that the Conservancy enact "careful, systematic, and strict procedures that will ensure compliance with all aspects of the spirit and letter of rules for charitable contributions."[8] The panel applauded a staff recommendation that the Conservancy refuse to sign a donor's Form 8283 to verify a tax deduction unless it could ascertain that the donor's appraiser is "state-certified, not barred from practicing before the IRS, and has experience appraising conservation lands and easements." Further, the panel approved the staff recommendation that the Conservancy ascertain whether the appraiser "uses generally accepted professional appraisal standards, accounts for the enhancement to any neighboring property owned by the donor, and certifies his or her awareness of any conflict of interest."

These recommendations, like many others offered by the advisory panel related to improvements in governance and management practice, serve as a valuable model that should be studied by other nonprofit organizations for possible adoption or adaptation. While few gifts of tangible property, beyond land donations and a small percentage of fine art objects, are of sufficient financial value to justify the expense involved in ascertaining appraisals to the extent recommended for The Nature Conservancy, ***all nonprofits should establish and follow clearer standards for accepting the Form 8283 estimates provided by donors to support tax deductions for contributed property.***

In crafting new proposals to address possible taxpayer abuses in claiming tax deductions for charitable donations, Congress should establish appropriate thresholds for the financial value of those deductions to ensure that it does not create barriers inadvertently to accepting contributions by responsible charities. Further investigation is called for concerning the costs of responsible appraisals and systems for the certification of appraisers to avoid unwanted, unintended consequences of discouraging responsible donors while leaving loopholes for those who would manipulate the system for personal gain.

iv) Donor-Advised Funds. Donor-advised funds have long provided a powerful tool for people of modest means to participate in philanthropy in a meaningful way. Donors make an initial irrevocable gift to a qualified public charity, frequently a community foundation, and are able to maintain some involvement in how those funds are distributed and invested for charitable purposes while relinquishing legal and financial filing and reporting requirements to the public charity where the donor-advised fund is held. Virtually all community foundations and other public charities offering donor-advised funds have well-established policies and procedures in place governing the involvement of donors

[8] Report of the Governance Advisory Panel to the Executive Committee and the Board of Governors of The Nature Conservancy, March 19, 2004, page 16.

and the use of the funds to guard against possible abuse. A few individuals and corporations have, however, taken advantage of the lack of clear legal requirements for donor-advised funds and used those funds for personal gain.

President Bush offered legislative proposals governing donor-advised funds as part of his fiscal year 2001 budget, citing a desire to make it easy to use donor-advised funds, encourage the growth of these philanthropic vehicles, and minimize possible abuses with regard to benefits to donors and their advisors. President Clinton also offered similar proposals in the final years of his administration. The charitable community has responded positively to these proposals and has offered many specific recommendations to ensure that legislation will meet its intended goals. In particular, the Council on Foundations' Proposal to Strengthen the Legal Framework of Donor-Advised Funds, based on extensive work by its Community Foundations Leadership Team, recommends the development of a "bright line" test to prevent compensation and other inappropriate financial benefits to donors, their advisors, or their family members; clarification of the distribution rules and requirements for donor-advised funds; and increased penalties for violations of the rules governing donor-advised funds. ***Congress should consider seriously the well-developed recommendations of the Council on Foundations and other charities as in crafting legislation regulating donor-advised funds to ensure that the legislation will address appropriately possible abuses without discouraging the development of these valuable philanthropic vehicles.***

v) Travel and Hotel Expenditures. Concerns about inappropriate travel expenditures, including hotel accommodations, have also been raised in congressional debates over provisions to limit the administrative costs of private foundations in H.R. 7, the Charitable Giving Act of 2003, as well as in media reports. Travel costs can vary substantially based on the amount of advance notice for securing accommodations and the availability of accommodations that meet the needs of the group by size, security, meeting rooms, and other issues. It is often necessary for foundations and charities to require their board and staff to travel to locations nationally and internationally where they operate or fund programs to ensure adequate oversight and understanding of the community needs those programs endeavor to address.

Tax law and regulations might provide clearer guidance for foundations and charities to determine what are "fair and reasonable" travel costs and expenses, but it is important that those guidelines provide sufficient flexibility to allow charities and foundations to meet, confer, consult, and collaborate with colleagues and partner organizations to further their charitable purposes.

C. Improving Self-Regulation and Practices within Voluntary Sector

The diverse nature of the charitable sector encompassing organizations with vastly different budgets, missions, operations, and spheres of endeavor makes it extremely difficult to apply a "one-size-fits-all" set of standards that, to be applicable, does not

settle on the lowest common denominators of practice. Some categories of nonprofit organizations—hospitals and health clinics, higher education institutions, and specific types of social service organizations—are well organized with established systems of accreditation and clear standards for many governance practices. Some membership associations serving museums, performing arts organizations, religious institutions, organizations working overseas, environmental groups, federations of health and human service organizations, and state-wide associations of nonprofits have developed comprehensive voluntary standards for management and governance practice and provide some training and education to assist organizations in complying with those standards. There are standards that have been developed for organizations that serve particular geographic regions. Some cross-sector "watchdog" organizations, such as the Better Business Bureau Wise Giving Alliance, have developed specific standards for organizations that solicit funds from the general public and review and provide public reports about the compliance of nonprofit organizations with those standards. INDEPENDENT SECTOR earlier this year released a statement of values and code of ethics intended as a model for use by charities and foundations. A range of different foundation groups, including community foundations, large private foundations, and corporate giving programs, have developed good governance principles that can serve as excellent prototypes for the rest of the foundation community. There are also substantial segments of the sector with no organized self-regulation.

This patchwork of standards for good practice, accreditation, and other self-regulatory mechanisms causes confusion for the public and for staff leaders and boards of directors within the sector. The time has come to explore a more holistic, national-local federated system that provides, where it makes sense, consistent standards of governance and practice and effective disincentives to wrongdoing. A national effort might concentrate on sharing uniform standards of good practice where they apply, reconciling different standards of practice when they are contradictory, and still recognizing the diversity that exists among sector organizations. It should include investing further in existing successful programs, identifying current gaps in standards, and filling them where needed.

Our nonprofit sector would be well served to use this window of opportunity to explore whether it is advisable to create an independent national entity and/or state entities, with public-private funding, that would establish ethical and best practice standards for voluntary sector governance, financial management, and operations. This would require a serious investigation of models from other industries and countries, as well as further study of the current successful regional and sub-sector standards programs, such as those established by the Evangelical Council for Financial Accountability and the Standards for Excellence program of the Maryland Association of Nonprofit Organizations, now being replicated in five states. Moreover it might examine how best to connect such entities and build on the good programs that already are in place.

This national effort also must involve a continuing education campaign to share with charity and foundation leaders information about legal requirements and best practice standards, including technical assistance to aid charities and foundations in moving

toward best practice standards and identifying and resolving problems before they escalate. This effort should build upon the work already being conducted by organizations such as CompassPoint in the San Francisco area and many others.

There is private philanthropic interest in exploring the development of such a national effort, but the successful implementation of this critical work will be an ongoing challenge and will undoubtedly require joint public-private support that may include some additional fees on a sliding scale.

V. CONCLUSION

Mr. Chairman, Mr. Baucus, and distinguished Members of the Committee, I have shared some recommendations for how the voluntary sector and government can work in concert to strengthen effective governance, practice, and accountability of the nonprofit sector. Some of these actions warrant immediate attention and implementation, while others will require more careful consideration and deliberation, if they are to be useful. I conclude by calling to your attention the numerous excellent initiatives already underway in all parts of the country, by groups large and small, that are focused on improving practice within the charitable community. Public charities and private foundations stand ready to work with you to move this agenda forward.

We in the nonprofit and philanthropic community are keenly aware of our responsibility to take on these challenges, but also to describe the outstanding accomplishments of so many organizations and the central role charitable organizations and philanthropies play in their communities, nationally and internationally. We know that you share our appreciation of the value of the sector and it is in that spirit that together we look for the most effective ways to preserve its important contributions.